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Stanley Sporkin

THE SEC CAN NO LONGER REGULATE FROM BEHIND

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Judge Sporkin discusses the future of SEC regulation. He first examines the successes of the SEC's past regulation practices when the SEC was a more proactive agency. Judge Sporkin then argues that failing to deal with issues before they present themselves often leads to financial crises which, when they occur, places the SEC in the untenable position of trying to put the "toothpaste back into the tube." Simply put, he asserts that regulators, particularly the SEC, must be proactive in overseeing the functioning of the financial markets and their participants. As he puts it, regulators cannot wait and "regulate from behind."

It is a real privilege for me to be here to discuss an issue of great importance to the financial well-being of this country. The SEC is an extremely important agency. As far as I am concerned, it is one of the best agencies in all of government. It has an incredible task and discharges its responsibilities reasonably well. Having said that, it does not mean the SEC can rest solely on its well-deserved laurels and not subject itself from time-to-time to critical scrutiny.

As someone who spent twenty years at the agency and truly admires and believes in its mission, I have always been interested in its state of well-being. I have, over the years, found it of interest to look at the agency from both the perspectives of its current agenda and those of the past.

Working through this exercise, I found some remarkable distinctions. When I talk about the past, I'm largely referring to the twenty years that I was at the SEC—the 1960s and 1970s. While

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arguably those years moved at a more modest pace, there are still some remarkable differences that cannot be attributed solely to the pace of events.

In those years, the Commission seemed to be more aware of changes in the industry. The option markets were just coming of age. The Commission gave them as thorough a review as reasonably conceivable. In other areas, as well, the Commission seemed to be on top of industry moves. Some of the most basic and dramatic developments in the securities field occurred in those years. The Commission, in the landmark cases of *Cady Roberts*[1] and *Texas Gulf Sulphur*,[2] commenced its war against insider trading abuses, a war that continues to this day at a high octane level.

Largely as a result of the SEC's initiative, Congress passed the Foreign Corrupt Practices Act,[3] as well as important takeover legislation. It was responsible for the abolishment of fixed commission rates as then existed in the exchange markets.[4] The SEC was creative in other ways. It came up with the Rule 144 concept that permitted sales of unregistered securities to leak into the marketplace in a non-disruptive fashion. The Enforcement Division was created, which allowed the Commission and its staff to be able to more effectively target and deal with abusive industry practices. The "Wells" process was introduced, which not only exists today, but also has been copied by other government agencies.[5] Rule 15c2-11 was another important rule that emerged.[6] This rule rid the marketplace of so-called "numbers trading," a phenomena that distorted the marketplace by allowing penny stocks to be traded way out of their normal range. Sometimes worthless stocks would be traded for twenty, thirty, forty dollars and even more a

1. Cady, Roberts & Co., 40 S.E.C. 907 (1961).

2. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part, rev'd in part* SEC v. Texas Gulf Sulphur Co. 401 F.2d 833 (2d Cir. 1968).

3. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977).

4. Securities Exchange Act of 1934, 15 U.S.C. § 78f(e) (1975); Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 34-11203, 6 SEC Docket 147 (Jan. 23, 1975).

5. KENNETH B. WINER & SAMUEL J. WINER, SECURITIES LAW TECHNIQUES § 88.10 (2010); SEC. AND EXCH. COMM'N DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL 22-28 (2012); *see also* Bradley J. Bondi, *The SEC's Wells Process Turns 40*, LAW360, Aug. 31, 2012, *available at* http://www.buckleysandler.com/uploads/36/doc/Law-360_The-SEC's-Wells-Process-Turns-40.pdf.

6. Initiation or Resumption of Quotations without Specific Information, 17 C.F.R. § 240.15c2-11 (2012) (enacted in 1971).

share.

The internal investigation process arose out of corporations' need to insure compliance with the Foreign Corrupt Practices Act, as well as other provisions of the securities laws. The compliance concept, as we know it today, can trace its origins to the SEC's Enforcement Program. This occurred largely in response to the SEC's adoption of its market access strategy.

This move came from the SEC taking aim at the entities that profited from the unlawful acts of their employees. The strategy was designed to provide incentive to those organizations that gave access to the marketplace to police themselves; in effect, the entity itself was to become the first responder. In response to the SEC's actions against entities, the private sector developed compliance programs to protect the organization from being sued by the SEC. This concept caught on and spread to even non-SEC-regulated companies. The defense contractor sector picked up on this internal policing device. This is just a short list of the many accomplishments that arose out of the agency's mid-twentieth century adventures.

As we entered into the last part of the twentieth century, there was a dramatic change. Regulation was heralded as the enemy of free markets. The Milton Friedman Chicago View emerged with the thesis that free markets were the best form of regulation. The word "Free Markets" became the cry of the day. It spooked many of the regulators who backed away to a certain extent from their responsibilities. I believe this had some impact on the SEC. I cite the role played by the then Chairman of the SEC in opposing the then Chair of the CFTC's desire to regulate derivatives.[7]

There is no question that our markets are the best in the world and that our overall free market philosophy certainly cannot be questioned with the caveat as mentioned by President Obama in his Inauguration Speech to the effect that free markets, in order to sustain themselves, need rules that insure fair competition as well as overall

7. The Chairman of the SEC was Arthur Levitt and the Chair of the CFTC was Brooksley Born. "They were totally opposed to it," Born says. "'That puzzled me. What was it that was in this market that had to be hidden?'" John Carney, *The Warning: Brooksley Born's Battle with Alan Greenspan, Robert Rubin and Larry Summers*, BUSINESS INSIDER, Oct. 21, 2009, *available at* http://www.businessinsider.com/the-warning-brooksley-borns-battle-with-alan-greenspan-robert-rubin-and-larry-summers-2009-10.

fairness in the marketplace.[8]

During this deregulation mood, many changes took place. The private sector took advantage of this state of affairs and introduced many innovative changes, some benefited society, and some were unnecessarily destabilizing. During this period we saw the creation of credit default swaps, synthetic securities (whatever they are), mortgage-backed securities, high frequency trading, and derivatives of all kinds. To a certain extent, the regulators were nowhere to be found until the excesses generated by these new products brought about adverse consequences in the marketplace. As a result, the cry for more regulation came from the investing public as well as from the financial markets themselves. Hearing these cries, Congress responded and enacted two very encompassing pieces of legislation, namely Sarbanes-Oxley[9] and Dodd-Frank.[10]

My thesis is that this did not have to happen. During these periods, when regulation becomes out of favor, the SEC and the other regulatory agencies must stand their ground. They cannot allow the industries they regulate to do anything they want, and only stop them when they have gone so far as to bring about a financial crisis. The various studies of our most recent financial crises clearly show that the SEC should have had a more vigorous presence. Certainly, the SEC took action in some of the more egregious cases. This form of regulation by exception cannot do it by itself. It needs a robust regulatory program to partner with it on a real time basis.

Simply put, regulation from behind is a prescription for failure.

We, at this very time, find ourselves ready to be tested again. There is a new deregulation mood coming into existence. It has, as its goal, the scaling back of Dodd-Frank and the tearing down of many of the investor protection measures that were created over the years that addressed the issuance of new securities of small and unseasoned companies. Certainly, the new JOBS Act[11] will put the

8. "[A] free market only thrives when there are rules to ensure competition and fair play." President Barack Obama, Inaugural Address (Jan. 21, 2013).

9. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301-08, 116 Stat. 745, 775-85 (2002) (codified at 15 U.S.C. §§ 78j-1, 7241-46).

10. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. §§ 5301-5641).

11. Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of the U.S. Code).

SEC to the test. As a whole, the SEC must become more proactive, and its various divisions must work much more closely together as they once did. The agency must recognize it is foremost a regulator, and as such, it must not over rely on its enforcement arm to bring about compliance.[12] Putting individuals out of the business or in jail should not be its only mission. Ideally, foresight should be given as equal a role as hindsight. While I know it will be difficult, a reoriented Commission with its highly capable members and staff should be able to meet the challenge.

12. During my tenure at the SEC, we were faced with a new practice of East Coast brokers paying their obligations to clients by issuing checks on West Coast banks. The West Coast brokers engaged in the same practice in order to gain a return on the float to the detriment of clients who had to wait days to receive the right to use their money. To eradicate this activity, the Commission could have either proceeded against the misbehaving brokers on an individual case basis, or it could simply issue a release condemning the practice. By choosing the latter, the practice immediately ceased. This is how regulation can obtain the most effective impact for its efforts. There are no statistics to be obtained of cases brought and nobody was put behind bars. The practice was merely brought to an end. The so called "quasi-amnesty" program of self-investigation brought in the early stages of the FCPA is another example of effective, broad-based regulation without individualized punishment.